

Egert, Balazs; Kierzenkowski, Rafal

Article

Challenges to Sustain Poland's Growth Model

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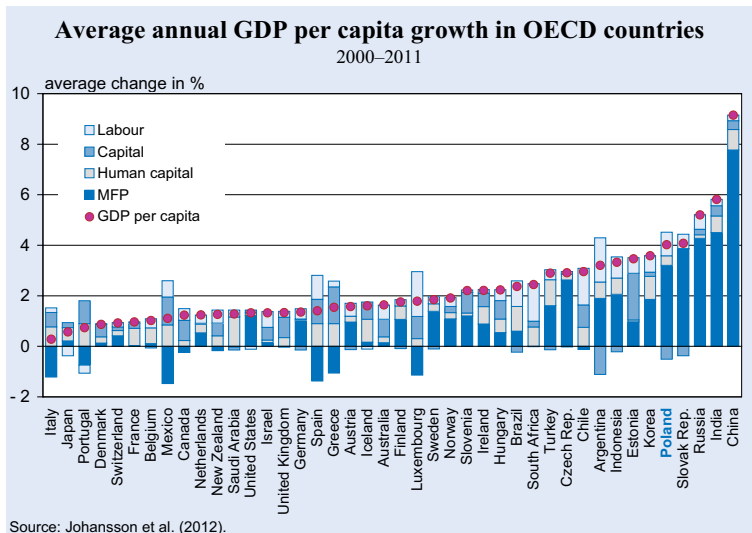
CHALLENGES TO SUSTAIN POLAND'S GROWTH MODEL

BALÁZS ÉGERT AND
RAFAŁ KIERZENKOWSKI*

Although past growth performance has been strong ...

Poland recorded robust GDP growth since the beginning of the transition process and showed great resilience during the global crisis, which led to pronounced gains in the standards of living. The average annual growth rate in GDP per capita reached 4.0 percent between 2000 and 2011, *versus* 1.8 percent for the OECD average, and was higher than in other Central and Eastern European countries (Figure 1). Between 2000 and 2011, rises in labour productivity fed the catch-up process mainly owing to advances in multifactor productivity, which made a contribution of above 3 percentage points to per capita income growth. The liberalisation of the domestic economy coupled with greater knowledge and technology transfers from abroad led to major improvements in labour efficiency. However, despite significant increases in the capital stock, capital intensity subtracted 0.5 percentage points from annual growth in GDP per capita. This was simi-

Figure 1



Source: Johansson et al. (2012).

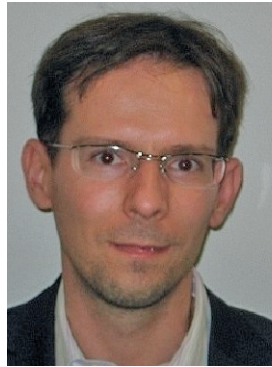
lar to the Slovak Republic, but contrasted with a positive contribution recorded in Estonia, Slovenia and Hungary. Therefore, Poland's growth model benefitted comparatively less from foreign direct investment inflows as the business climate and regulations were less conducive to greater investments. Human capital contributed positively to growth by almost 0.5 percentage points, more than in other regional peers. This reflects Poland's progress in educational attainment and the quality of its secondary education as confirmed by good PISA (Programme for International Student Assessment) scores, particularly in mathematics and science. Finally, steady decreases in the unemployment rate underpinned employment rises and growth, notably driven by better training of the unemployed, a higher share of workers with better qualifications and lower labour market mismatches (Kierzenkowski *et al.* 2008).

... there is a long way to go to close the gap in per capita income to the most developed OECD countries

Despite its strong performance in the recent past, per capita income is substantially lower compared to the United States and this gap is mainly explained by a shortfall in labour productivity (Figure 2).¹ Although overall labour resource utilisation is not significantly lagging behind, its breakdown shows that the average number of annual hours worked are high and the activity rate is low. The combination of low labour market participation and a high unemployment rate leads to a low employment rate. The participation rate of the working age population (15 to 64 years) in Poland is among the lowest in Europe: around 65 percent against rates close to or even above 80 percent in the Nordic countries (see Figure 3). The main explanation for this trend is the reduced activ-

* OECD Economics Department. The views of the authors expressed here do not necessarily reflect those of the OECD.

¹ Per capita income (GDP over population) can be broken down into labour productivity (GDP over total hours worked) and labour utilisation (total hours worked over population).



ity of older workers, low-skilled workers and women. Figure 3 shows that only every second individual between the age of 50 to 64 years is active against four out of five in Sweden. Even more striking is the fact that only one third of individuals with low educational attainments participates in the labour market, compared to a participation rate of 70 percent in Switzerland. The female participation rate is also low by European comparison, despite the fact that the absolute level of 60 percent is less striking.

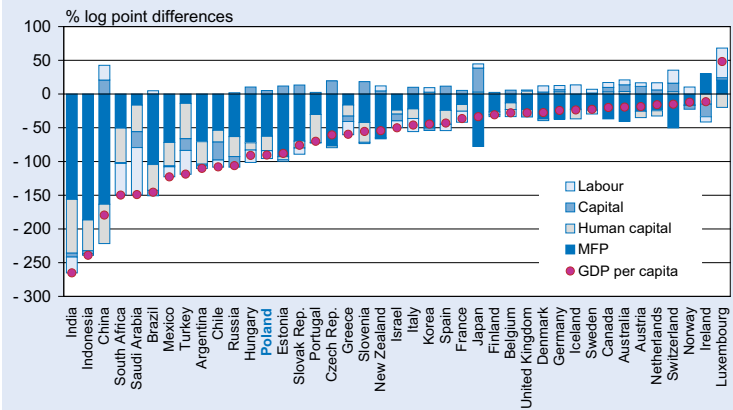
These low participation rates are a heritage of transition from central planning to a market economy: the collapse of heavy industries after the start of the economic transformation left behind a mass of low-skilled middle-age men and women, who did not have the ability to update their competences. Disability and early retirement pension schemes offered them an escape route to withdraw from the labour market. OECD data indicate that the effective retirement age in Poland is among the lowest in the OECD, especially for women, and that the gap between the effective and the official retirement age is substantial. In addition, public spending on incapacity benefits amounted to almost 3 percent of GDP in 2007, above the OECD average, but close to figures of fellow transition countries, indicating the large number of individuals involved.

Population ageing is a major challenge for growth

Recent OECD long-term projections suggest that Poland's growth model will face major challenges as the population ages owing to declines in fertility rates and overall gains in longevity (Johansson *et al.* 2012). These projections indicate that per capita income growth will be among the lowest in Europe over the decades to come (Figure 4). The working-age population (15–64) as a share of the total population, currently above 70 percent, is projected to drop to below 55 percent by 2060. In parallel, the old-age dependency ratio measuring the share of the population older than 65 to working-age population (15–64) is expected to jump from around 20 percent in 2011 to close to 35 percent in 2030 and should exceed 60 percent in 2060. If policies remain

Figure 2

Per capita income in OECD countries at constant USD 2005 PPS, log difference of the US relative to other OECD countries



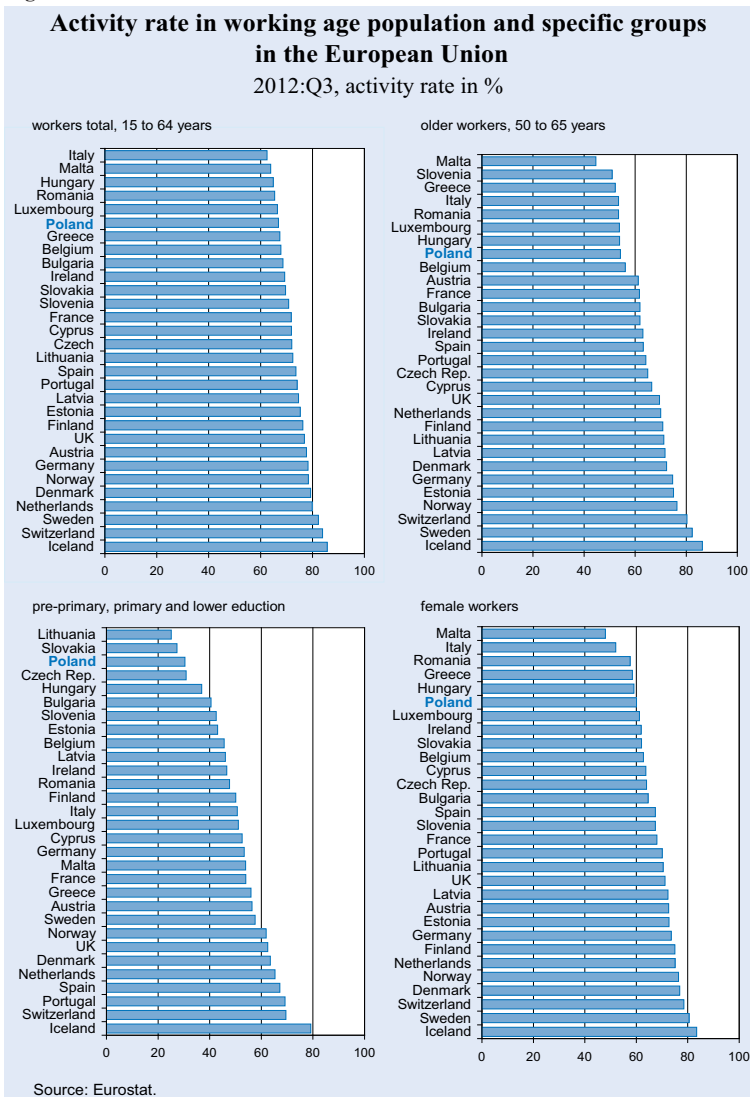
Source: Johansson *et al.* (2012).

unchanged, these developments should lead to one of the largest declines in labour force participation in the OECD over the next 50 years, of over 10 percentage points among the population aged above 15 years. This decline would only be slightly contained by gradual structural reforms in the baseline scenario, notably implemented on the assumption of further trend expansion in educational attainment, an indexation of the legal pensionable age to life expectancy, and a convergence of comparatively stringent product market regulations to the average regulatory stance observed in the OECD. As a result, population ageing will be a major drag on trend growth, which should be mainly driven by efficiency improvements and, to a much smaller extent, improvements in human capital. More precisely, Poland's growth in GDP per capita is projected to fall from 4.4 percent between 1995 and 2011 to 2.6 percent over the next 20 years and to just 1.4 percent between 2030 and 2060 in the baseline scenario. The catching-up should be slow: the gap in GDP per capita *vis-à-vis* the United States should shrink by about 20 percentage points over the next 50 years, but should remain high in 2060.

Policy measures are needed to sustain Poland's growth model

Bold policies are needed to counteract the adverse effects of population ageing as we have seen that per capita income growth will sharply slow down in Poland over the coming decades under the scenario of gradual policy changes. To head off such daunting developments, policymakers have to act more

Figure 3



forcefully to boost labour productivity and labour utilisation.

Increasing labour resource utilisation

Poland's population ageing is projected to be one of the most pronounced in the OECD and an increasing dependency ratio will reduce labour utilisation. Let us start by looking at ways how policies could counteract such developments in Poland.

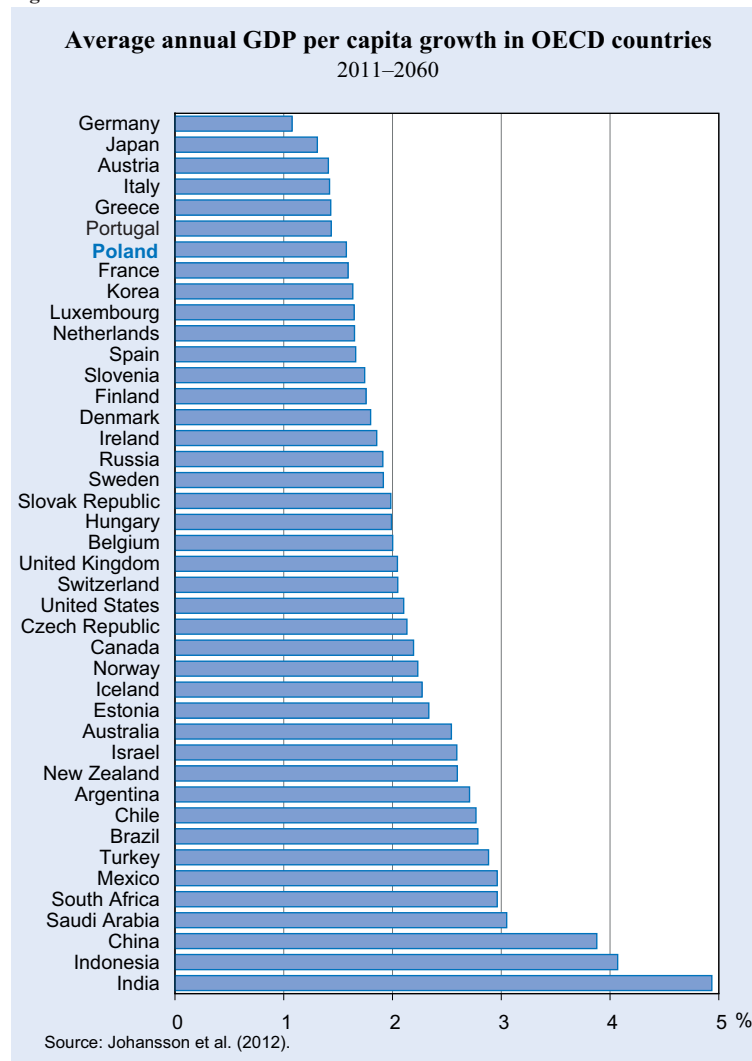
The first avenue for policy action is to keep people at work longer by increasing the effective retirement age. Poland implemented, in a very well thought-out manner, a comprehensive pension system reform in 1999: the first pillar based on notional accounts, and the accompanying fully-funded second pillar, both ensured actuarial neutrality. Such a system offers people the choice to work longer and receive higher pen-

sion benefits or to retire earlier, but at the expense of a low pension benefit. Because the calculation of pension benefits is related, in an automatic fashion, to life expectancy, longer lives would mean that people would need to work longer to get decent old-age pensions. Nevertheless, the legal retirement age serves as an important social benchmark and influences people's retirement decisions. People may also be shortsighted and realise that they should have worked longer only once they receive the pension benefits. Hence, it is important for the government to increase the legal retirement age in line with, or even beyond, gains in life expectancy and to improve the population's financial education so that people understand the need to work longer (OECD 2012). The 2012 pension reform raised the legal retirement age to 67 both for men (from 65) and women (from 62) – although some potentially generous early retirement possibilities were opened up to soften up this increase (OECD 2013). This reform is welcome, but is likely to be insufficient as reflected by the

baseline scenario, and additional policy steps are needed to reduce the negative impact of declining labour utilisation on growth. However, people will only be able to work longer if they age in a healthy manner. In order to improve the relatively poor health status of the Polish population (which can be explained by the country's level of economic development), OECD (2012) recommends, among other things, i) improving access to health care, ii) enhancing hospital management, iii) carefully designing new private health insurance and iv) developing a long-term-care strategy.

Policymakers could further increase participation rates by effectively closing channels of early retirement. In particular, the government should continue to further align, after the 2012 pension reform, the generous early retirement schemes of uniformed service and eliminate those for judges and miners

Figure 4



(OECD 2013). An important driver of the low female activity rate at older ages are generous survivors' pension benefits. Women do not need to have a full career to benefit from an old age pension, especially if their partners pass away earlier (which is likely given the lower life expectancy for men). According to the OECD's social expenditure database, spending on survivors' benefits accounted for 2 percent of GDP in 2007, well above the OECD average of 1 percent. The costs of survivors' benefits should be internalised either *via* higher contribution rates imposed on the primary earner, or through a lower pension benefit if the pension is to be passed on to the survivor partner. Internalising these costs would incentivise women to work longer. In 2008, the length of post-maternity parental leave in Poland was almost three years and the highest in the whole of the OECD. This keeps mothers away from the labour market too long, especially in the case of consecutive childbearing, and thus permanently lowers the female participation rate.

women. Therefore, the government would be well advised to come up with a coherent family policy framework, and in particular to develop pre-school childcare infrastructure (OECD 2013).

Persistently high unemployment rates are also an important factor of subdued labour utilisation. The unemployment rate is high for young people and the unskilled. Active labour market policies, including activation and retraining, is essential to get people back into jobs. Poland clearly has a deficit in this area. The taxation of labour income can also act as a drag on the demand for and the supply of labour. The personal income tax cuts and social security contribution reductions decided in 2008 lowered the tax wedge to the OECD average, but were partly offset by a rise in disability pension contributions and the nominal freezing of the personal income tax schedule. In fact, the OECD has long advocated changing the tax mix by shifting taxes from labour (and capital) to those

The dependency ratio will rise not only because people will live longer, but also because Poland's fertility rate is about 1.4 percent, which is well below the level needed to stabilise the population. Low fertility rates will determine the size of the working-age population for the coming decades. Yet, looking further ahead, policymakers should start to consider how to encourage childbearing. Empirical studies find that family policies that diminish the cost of raising children *via* a combination of financial and non-financial incentives have a significant effect on fertility rates in the OECD (D'Addio and Mira D'Ercole 2005; Luci and Thévenon 2012). In Poland, financial incentives are not particularly high. The insufficient number of places in pre-school childcare also makes it difficult to reconcile family life with work and discourages childbearing. However, the insufficient provision of pre-school childcare also contributes to the low female participation rate as the opportunity cost of staying at home is low, especially for low-income

that penalise growth less, namely green taxes and property taxes.

Boosting labour productivity

The government should also consider reforming the tax system because shifting the tax burden to less harmful taxes would spur productivity gains via capital deepening (more investment). Eliminating tax expenditures and ensuring more neutrality across different asset classes would also contribute to a better allocation of productive resources and reduce administrative costs and the costs of tax compliance. The preferential tax treatment and generous health care insurance system for farmers (KRUS) lead to resource misallocation and inefficiencies in the agricultural sector. An insufficient housing supply of private rentals in urban areas also impedes workers' geographical mobility and thus efficient resource reallocation.

Another important aspect policymakers need to look into in Poland is product market regulation. Despite successive privatisation programmes launched in 2008, the State still plays an important role in the economy. There is no economic reason why the government should be involved in potentially competitive segments of network industries, in the financial sector, airport operators, the mining and chemical industries. Less government involvement would improve allocative efficiency and thus boost productivity. Moreover, indirect government interference *via* complicated regulations also puts an unnecessary burden on doing business. According to government estimates, the costs of regulation for businesses amounts to 5 percent of GDP per year. Against this background, the authorities launched a programme to cut red tape and to simplify legislation governing the economy. Yet, according to the World Bank's Doing Business 2012 report, it takes a month to set up a business and almost a year to obtain construction permits, and it is very complicated to pay taxes in Poland (OECD 2012). The government is aware of these difficulties, but it needs to push ahead more firmly in these areas. Thankfully the Government indeed intends to liberalise a large number of professional services.

Competition in mining, electricity, gas and telecommunication is unsatisfactory. Beyond public disengagement from these sectors, improved overall regulatory framework should enforce more competition (including broadband internet), which could, in turn, help spur productivity. Financial deepening, essential

for better access to credit, could be promoted *via* a consolidation of the fragmented landscape of cooperative banks and an improved legal framework for the use of collateral (OECD 2012).

Network infrastructures are still not very well developed. Despite considerable efforts to expand the motorway and highway networks, largely financed by EU funds, there is scope to improve the road network. Similarly, the railway network needs to be upgraded further. The Doing Business 2012 report identifies that it is not easy for businesses to get connected to the electricity network. This is partly because of the poor state of the distribution network, which critically needs investment. Due to the relative underdevelopment of these networks, additional investment would most likely improve productivity.

Upgrading human capital is crucial for long-term productivity growth. Skill mismatches remain significant in the Polish economy, despite rising educational attainment. Against this background, the government recently announced that a greater emphasis will be put on hard sciences in tertiary education. The primary and secondary educational system has gained strength over time, which is reflected in improved PISA scores. The 2011 tertiary education reform aims to develop vocational education. Further improvements could be achieved by enhancing the training system and encouraging lifelong learning, increasing the feedback loop between the education system and the economy's needs. Raising the quality of the tertiary education system through reinforced quality assessment of higher education institutions and giving more space to competition and transparency in the promotion of staff would also upgrade education (OECD 2012; OECD 2013).

Policies aimed at boosting productivity should encourage innovation to push the technology frontier and/or, more importantly in Poland's nearer future, to close the gap to the technology frontier. How smoothly technology adoption goes depends on the interplay between education, infrastructure and product and labour market regulation. Poland could rely more heavily on tax credits to encourage innovative activities. Research funds should be spent in a way that creates critical mass and maximises spillover effects in academia and the economy. Giving more autonomy to universities in terms of budgeting and human resources would underpin the emergence of research centres. The government should also better intergrade universities with businesses and create a framework

for increased mobility among researchers between the private and public sectors (OECD 2010).

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